

100% of the Series H Warrants, at an initial exercise price of \$1.13 per share, were callable by the Company if the market value of its Class A Common Stock exceeded 250% of \$1.13 for a minimum of 15 business days during any twenty consecutive business day period. If exercised in full, the Series H Warrants would generate up to an additional \$4,077,671 for the Company.

54. In the Form 10-K/A filed on June 30, 2003, the Individual Defendants and the Company expanded on their comments made in the May 15th press release concerning the fruition of Wave Systems' "long-held vision of revenue-producing trusted computing services" and made the following forecast for revenue growth in fiscal 2003:

Revenue and gross margins during the year ended December 31, 2002, versus the same period in 2001 is indicative of a downward trend, with neither period showing significant revenues. The amount of revenues in both years has not reached a level that would contribute significantly to Wave's operations and has been sporadic. **Wave does not foresee that it will achieve significant revenues at least until the latter part of 2003. Our sales forecast for the year ended December 31, 2003 approximates \$5 million in gross margin contribution.**

However, this forecast is not supported by a backlog of orders at this time, but rather the anticipation that various deals that we are currently pursuing will close. Wave continues to work towards solidifying strategic alliances with the major personal computer manufacturers to force collaborative efforts to distribute its products to consumers . . .

(Emphasis added.)

Improper Statements During The Relevant Period

55. On July 31, 2003, with the market primed by the Individual Defendants' statement concerning an anticipated revenue stream, the Individual Defendants caused the Company to issue a press release entitled "Wave Systems Announcement." The press release stated in part:

Wave Systems Corp. announced an agreement today with Intel Corporation that will help enable both companies to accelerate the development and deployment of trusted applications and services for safer computing on personal computer platforms.

The agreement will enable Intel to bundle Wave's software and services with a future Intel desktop motherboard, targeted for trusted computing platforms.

"Wave helps fill a critical requirement for trusted computing services," said Michelle Johnston, acting director of marketing for Intel Desktop Board Operations. "We believe the EMBASSY® Trust Suite software will provide good value for our customers looking for trusted computing applications."

"Wave has been working closely with Intel on the development of application and service solutions," said Brian Berger, senior vice president, Global Business Development, Wave Systems. "Both companies believe that in order to accelerate adoption in the marketplace, it is critical to identify and offer an attractive introductory set of services and high value applications. We are delighted to be working with Intel by providing solutions for this emerging market.

"Wave believes that a portfolio of services will make trusted computing an important part of the personal computing market going forward. It is our job, to work with industry leaders like Intel, to help identify and develop those services that will bring the most value to the enterprise - as trusted hardware is deployed and a more secure computing environment becomes a reality." Berger said.

56. The market reacted positively to the news of the purported Intel deal. At the close of the market on Thursday, July 31, 2004, Wave Systems' stock increased from its previous day's close of \$0.84 per share to \$2.25 per share, realizing a gain of 168%. Volume on that day was approximately 19 million shares traded, as compared to Wave Systems' average daily volume of only 199,136 shares.

57. Demand for Wave Systems' shares continued the day following the announcement. As reported by CBS Market Watch, on Friday, August 1, 2003:

Demand for Wave Systems' shares soared again Friday, a day after the developer of computer security technology more than doubled **on news of an important partnership with chip heavyweight Intel.**

The stock (WAVX) jumped 98 cents, or 43.1 percent to \$3.23, in morning dealings. Volume climbed above 22.1 million, good for the third slot on the Nasdaq's most-active chart.

On Thursday, shares rose to \$2.25 from 84 cents on volume of 19 million.

Financial terms of the partnership weren't disclosed.

(Emphasis added.)

58. The Company's share price continued to climb during the morning of the third day of trading following Defendants' announcement of the Intel deal. As reported by Midnight Trader on August 4, 2003, "Wave Systems (WAVX) is up 14.4% on 275,000 Island [sic] shares this morning as traders look to push the column for the third consecutive day. The stock has been rocketing higher since Thursday when the company announced a supply and services contract with Intel (INTC)."

59. According to a former Wave Systems' employee who worked as an engineer in Wave Systems' California office from 2000 through August 2003, and had also worked as an engineer at Intel before joining Wave Systems, the Intel deal was considered by his contacts at Intel to be "a small deal." The former Wave Systems engineer's job at Wave Systems was to establish business relationships or strategic alliances" between Wave Systems and larger companies. He worked on the Intel deal because of his previous employment and connections there. The former Wave Systems engineer's contacts at Intel viewed the deal with Wave Systems as "kind of a joke," and were "very surprised" at the attention the announcement received. The

former Wave Systems engineer reported that Intel viewed the deal as not a lucrative one for Wave Systems.

60. The statements contained in ¶55 above were materially false and misleading, as the statements were incomplete. By the time the Intel announcement was made, the Individual Defendants and the Company had forecast Wave Systems receiving a significant revenue stream in 2003 from "various deals that we are currently pursuing." Having thus primed the market, the Individual Defendants knew, or recklessly disregarded the fact that the investing public would be misled by the omission of the specific terms of the Intel agreement, which terms merely provided Intel with non-exclusive licensing rights to use Wave Systems' products, without any minimum licensing requirement. Intel could choose to use or not use this licensing right. Thus, Intel was not obligated, and had not decided, to give Wave Systems its business. If the truth concerning the Intel "agreement" had been disclosed by the Individual Defendants, investors and shareholders would have learned that the purported deal with Intel was not likely to be a component of the anticipated "\$5 million in gross margin contribution" that the Individual Defendants had announced just before the start of the Relevant Period. Indeed, the Intel announcement was merely a skillfully timed hoax.

61. On August 4, 2003, the Individual Defendants caused the Company to issue a press release entitled "Wave Systems Makes Enterprise Applications More Secure Than Ever; IBM's Independent Software Vendor (ISV) Program Helps Wave Systems Create More Secure Applications for the Enterprise User." The press release which announced that Wave Systems had a partnership with computer giant IBM, stated in part:

Wave Systems Corp. today announced that the new Document Manager Vault and SmartSignature security software applications in Wave's EMBASSY® Trust Suite client software family work with the IBM Embedded Security Subsystem, a hardware and software-based security solution available on select ThinkPad notebooks and ThinkCentre desktops, to create more secure applications for the business user.

The compatibility of Wave's security software applications with IBM's hardware and software security solution is a result of Wave's successful participation in IBM's Independent Software Vendor program. This partnership is another example of IBM's commitment to help independent software vendors use IBM's hardware and software-based security system to make computing as secure as possible for the end-user.

"The early stages of any emerging market are critical. IBM has clearly established their leadership in trusted computing with their family of Embedded Security System personal computers," said Lark Allen, executive vice president, Wave Systems. "Wave's partnership with IBM will significantly help us in our objective to deliver open and interoperable solutions to business customers as trusted computing continues to evolve."

Leveraging the IBM security chip for personal computers, the Wave EMBASSY Trust Suite Client Business Edition includes the first of many new applications aimed at business users: Wave's Document Manager Vault and SmartSignature. Wave's EMBASSY Trust Suite represents one of the first portfolios of user software applications, administrative tools, and trust-based systems developed specifically around the new Trusted Computing Group (TCG) specification.

Wave's Document Manager Vault application offers a user-controlled vault for storage of private data, such as encrypted files and folders on personal computers. Document Manager Vault offers the choice of a simple drag-and-drop mechanism, as well as a set of integrated plug-ins for popular office tools to encrypt and decrypt any type of file on a local PC. By using IBM's Embedded Security Subsystem in conjunction with Document Manager Vault, sensitive data is protected even if the PC is lost or stolen.

62. The news was widely reported in the marketplace as a deal between Wave Systems and IBM where IBM would use the Company's software in certain IBM

products. As reported by CBS Market Watch on August 4, 2003, "[s]hares of Wave Systems are trading among the leading Nasdaq percentage gainers, up \$1.03, or 28 percent, at \$4.68. The security hardware and software firm announced a deal with IBM to use its software in certain IBM products."

63. In response to what was presented as another timely deal for Wave Systems, Wave Systems common stock closed at \$4.42 per share on August 4, 2004, up \$0.77 per share, or 21%, from its closing price of \$3.65 per share on the previous trading day, August 1, 2004. The volume of Wave Systems shares traded on that day was also extremely high at over 40 million shares.

64. On August 5, 2003, a Wave Systems spokesperson confirmed and furthered the market's perception of the Company's materially misleading August 4th announcement: that the IBM deal meant Wave Systems' product would be bundled with IBM computers. As reported in The New York Times, Wave Systems represented the deal with IBM as follows:

The Wave Systems Corporation said yesterday that it had agreed to a deal with IBM to embed its security software inside selected IBM notebook and desktop computers, in the latest in a string of deals for Wave Systems. The company, based in Lee, Mass., said its software would be available on selected ThinkPad notebooks and ThinkCenter desktops that include IBM's digital security subsystem.

Shares of Wave Systems rose 21.4 percent, or 77 cents to close at \$4.42. Shares of the previously thinly traded stock have risen sharply in the last three days, since Wave announced a deal with Intel to embed its software inside some internal computer chassis built by Intel. **Terms of the latest deal were not disclosed. But a Wave spokesman, John Callahan, said IBM computers with built-in Wave security would be available in the fourth quarter of this year.**

(Emphasis added.)

65. Defendants' misrepresentation that IBM had agreed to include Wave's software in IBM computers was also reported by Financial Wire on August 5, 2003 as follows:

Okay, forget the fact that Wave Systems Corp. is working off a net loss in 2002 of \$43.5 million on revenue of \$447,000, that it has been a long-time thinly traded stock or anything else we've noted. Traders obviously don't care, and **Wave Systems just keeps on dropping names, the latest being IBM Corp., to go with Intel Corp. and National Semiconductor Corp. After the shares of Wave Systems Corp. exploded Thursday for a 167.86% gain, it soared still another 62% on 63.7 million shares on Friday, and Monday just kept going, up another 21.10% to \$4.42 on 45.8 million shares traded. This all from a standing-still start after trading no shares and languishing under \$1 four trading days ago. Yesterday the company fueled the fire with an announcement it had agreed with IBM to offer Wave's security software as an option for IBM notebook and desktop computers. The company is up over five times its starting price, and the volume is some 100 times the average, which was close to zero.** Once again, terms were not disclosed, so traders remain in the dark as to the value of the deals to the company, and there is no analyst coverage to interpret the data. IBM did say that its security chips add \$25 to the cost of a computer, but there is no information as to how much Wave might see of that.

(Emphasis added.)

66. And on August 5, 2003, *Bloomberg* reported that "shares of Wave Systems Corp., a developer of online commerce and security technology that said it has enough money to last through Oct. 15, jumped more than five-fold in four days after saying that Intel Corp will use its software," according to Defendant Steven Sprague, "Intel will pay a license fee for bundling the software onto the computer circuit boards that Intel sells[.] ... Those fees typically range from 50 cents to \$1.50 per motherboard."

67. However, the Individual Defendants' and the Company's representations concerning the IBM deal were materially false and misleading, as Defendants knew, at

the time the statements were made, as Defendants knew, in that Wave Systems had merely established that its products were compatible, or would run on IBM's computers, not that IBM had partnered with Wave Systems and would be bundling Wave Systems' products with computers IBM shipped to its customers.

68. The combined effect of the Individual Defendants' and the Company's announcements and statements referenced in ¶¶55, 61 and 66 caused Wave Systems stock to soar. Shares of Wave Systems gained 426%, or \$3.58 per share from its closing price of \$.84 per share on July 30, 2003 to its closing price of \$4.53 per share on August 5, 2004 after reaching a high of \$5.24 per share earlier that day.

69. On August 5, 2003, Defendant Feeney sold 100,000 Wave Systems shares at \$5.00 per share for \$500,000, cutting his share ownership by 50%. Feeney had not before, nor has he since, sold Wave Systems shares. Feeney's untimely SEC Form 4 reporting same was not filed until August 21, 2003.

70. On August 6, 2003, Defendant Steven Sprague sold 150,000 Wave Systems shares at \$3.17-\$4.01 per share for \$533,841, cutting his beneficial Class A share ownership by 36%. Steven Sprague's untimely SEC Form 4 reporting same was not filed until August 22, 2003.

71. On August 19, 2003, Bushnell sold 10,000 Wave Systems shares for \$35,742. The sale accounted for all of his Wave Systems holdings. Bushnell's untimely SEC Form 4 reporting same was not filed until April 15, 2004.

72. Additionally, as will be further alleged below, it has been reported in the media based on comments made by Steven Sprague that Steven Sprague sold Wave

Systems shares in early August 2003, although any such sales have not been reported to the SEC.

73. While certain of the Individual Defendants were able to profit by selling their personally held Wave Systems shares at artificially inflated prices, Defendants' scheme to avoid the oppressive terms of the Series H Placement through the conversion of the preferred stock to Class A Common Stock was stalled. On August 7, 2003, Financial Wire reported that the SEC had "put the brakes on the company's proposal to ask for shareholders to authorize an increase of the company's float from 75 million shares to 120 million shares, necessary to keep it in business until the new promises can come to fruition." The shareholders vote had been scheduled for August 4, 2003. A shareholder vote was necessary to authorize the Company's issuance of additional shares of Class A Common Stock, above its current float, that would be required in the event the Series H shares became convertible to Class A Common Stock. Shareholder authorization was required under NASDAQ rules because the number of additional shares needed exceeded 19.99% of shares outstanding ("ShareCap") prior to the April 30, 2003 close of the Placement. Without the shareholders approval, Wave Systems would have been obligated to redeem the Class A Common Stock issuable upon conversion or exercise of the Series H securities in excess of 10,355,865 shares, to comply with NASDAQ listing requirements.

74. In the Company's Definitive Proxy Statement filed on August 8, 2003, the Company announced that its annual shareholders meeting was rescheduled to August 27, 2003. According to a report by the Financial Times on August 11, 2003, the shareholder vote on the proposed increase in its float from 75 million shares to 120

million shares has been reset by Wave Systems following a SEC review that a Company spokesperson said was mistakenly thought by some to have been an investigation.

75. On August 12, 2003, the Individual Defendants and the Company filed a Form S-3/A with the SEC relating to the registration of 1,700,000 shares of Class A Common Stock. The Form S-3/A was signed by each of the Individual Defendants. In the Form S-3/A, the Individual Defendants made the following representations under "Material Changes":

On July 31, 2003, Wave announced an agreement with Intel Corporation that will help enable both companies to accelerate the development and deployment of trusted applications and services for safer computing on personal computer platforms. The agreement will enable Intel to bundle Wave's software and services with a future Intel desktop motherboard, targeted for trusted computing platforms. Similar in nature to a previously announced March 2003 licensing agreement between Wave and National Semiconductor, Intel will pay a royalty fee to Wave for each unit shipped. Intel plans to introduce the new motherboard in the fourth quarter of 2003.

On August 4, 2003, Wave announced that it has partnered with IBM's Independent Software Vendor (ISV) Program. Wave's new Document Manager Vault and Smart Signature security software applications in Wave's EMBASSY Trust Suite client software family now work with the IBM Embedded Security subsystem, a hardware and software-based security solution available on select ThinkPad notebooks and ThinkCentre desktops. Wave's partnership with IBM enables Wave in its objective to sell and deliver open and interoperable solutions to business customers as trusted computing continues to evolve. Wave will try to interest other security chipmakers and motherboard suppliers in its product in the coming months.

76. The Individual Defendants statements contained in the Company's SEC filing described above were materially false and misleading at the time they were made. The Individual Defendants knew that the Intel deal would not generate the revenue

stream forecasted by the Company at any time in the foreseeable future, if ever, and that the IBM relationship was not fee producing. Contrary to the Individual Defendants' representations, the purported Intel and IBM deals were not "material changes."

77. On August 14, 2003, Wave Systems issued a press release highlighting the Company's performance in the second quarter of 2003 ("2Q03"), and for the six month period ending June 30, 2003. Wave Systems reported a net loss to stockholders for the quarter of \$6,274,000, or \$0.12 per share.

78. In the Company's earnings conference call with analysts to discuss the second quarter 2003 conducted on August 14, 2003, Defendant Steven Sprague for the first time described the Intel deal as a non-exclusive licensing agreement, with no minimum or maximum licensing requirements, "[t]hey can use it as broadly as they want or as little as they want." In addition, Steven Sprague stated that while the Company's products were compatible with IBM computer platforms, Wave Systems did not have a licensing arrangement with IBM. Despite this partial disclosure, the impact of the statements on the market for Wave Systems' shares was diluted if not totally eclipsed by Steven Sprague's simultaneous reinforcement of the Individual Defendants' earlier stated expectation for imminent, significant revenue growth. Defendant Steven Sprague forecast revenue breakeven on the Company's predicted revenue stream:

From a business perspective, we believe the market will start generating revenue for us really the end of this year in fourth-quarter, although I think the bulk of that revenue won't really be realized till a quarter after because it takes some time for those numbers to be reported back to us that this revenue is based primarily on the applications that are bundled with the platform, very much around a relationship that we've announced with Intel and the business model that was articulated in the press release.

* * *

We think the long-term scope in that business is tremendous and on a short-term basis we think we can reach the point where the company gets to cash flow breakeven sometime in 2004.... So the company has now access to the resources that we need in order to operate, the recent exercise of options which brought in additional cash was something that really helped to strengthen our balance sheet. We continue to work towards strengthening the overall company, and the ultimate way to do that is to drive the revenue base so this company reaches a cash flow breakeven position and we think that's very achievable in 2004.

(Emphasis added.)

79. In addition, during the August 14, 2003 conference call with analysts, Defendant Steven Sprague was specifically questioned by analysts as to when revenues would be seen by the Company:

Q. (John Stuart, National Media) So my infamous question is of leaving the lights on till all this happens, you feel like you're well-you're much more comfortable now than you were, say, four months ago? That we're going to have the resources and the wherewithal to keep the lights on until this unfolds?

A. (Steven Sprague) Very much so. The real challenge in this market has been when are the first units going to ship with scope and volume, and I think that we're beginning to be able to show that in the marketplace. **We certainly had a clearer view in it for the last couple of quarters, so we've been much more comfortable than perhaps our shareholders can be because it's hard to see the data that we have. But we're very comfortable. ...**

(Emphasis added.)

80. Defendant Steven Sprague's statements contained in ¶¶78-79 were materially false and misleading at the time they were made. Defendant Steven Sprague was aware that the forecasted revenue stream was a fabrication, pulled out of the air and created to mislead the investing public and artificially inflate the Company's stock. Defendant Steven Sprague knew that the Intel deal would not generate the revenue

stream forecasted by the Company at any time in the foreseeable future, if ever, and that the IBM relationship was not fee producing.

81. On August 18, 2003, the Individual Defendants caused the Company to file a Prospectus with the SEC relating to the registration of 1,700,000 shares of Class A Common Stock. The Prospectus made the following representations under "Material Changes":

On July 31, 2003, Wave announced an agreement with Intel Corporation that will help enable both companies to accelerate the development and deployment of trusted applications and services for safer computing on personal computer platforms. The agreement will enable Intel to bundle Wave's software and services with a future Intel desktop motherboard, targeted for trusted computing platforms. Similar in nature to a previously announced March 2003 licensing agreement between Wave and National Semiconductor, Intel will pay a royalty fee to Wave for each unit shipped. Intel plans to introduce the new motherboard in the fourth quarter of 2003.

On August 4, 2003, Wave announced that it has partnered with IBM's Independent Software Vendor (ISV) Program. Wave's new Document Manager Vault and SmartSignature security software applications in Wave's EMBASSY Trust Suite client software family now work with the IBM Embedded Security Subsystem, a hardware and software-based security solution available on select ThinkPad notebooks and ThinkCentre desktops. Wave's partnership with IBM enables Wave in its objective to sell and deliver open and interoperable solutions to business customers as trusted computing continues to evolve. Wave will try to interest other security chipmakers and motherboard suppliers in its product in the coming months.

82. On August 20, 2003, the Individual Defendants caused the Company to file a Form S-3 Registration Statement with the SEC relating to the registration of 12,593,880 shares of Class A Common Stock. The Form S-3 was signed by each of the Individual Defendants. In the Form S-3, the Individual Defendants made the following representations under "Material Changes":

On July 31, 2003, Wave announced an agreement with Intel Corporation that will help enable both companies to accelerate the development and deployment of trusted applications and services for safer computing on personal computer platforms. The agreement will enable Intel to bundle Wave's software and services with a future Intel desktop motherboard, targeted for trusted computing platforms. Similar in nature to a previously announced March 2003 licensing agreement between Wave and National Semiconductor, Intel will pay a royalty fee to Wave for each unit shipped. This licensing agreement is non-exclusive and there are no minimum licensing requirements on the part of Intel pursuant to the agreement. Intel plans to introduce the new motherboard in the fourth quarter of 2003.

On August 4, 2003, Wave announced that it has partnered with IBM's Independent Software Vendor (ISV) Program. Wave's new Document Manager Vault and SmartSignature security software applications in Wave's EMBASSY Trust Suite client software family now work with the IBM Embedded Security Subsystem, a hardware and software-based security solution available on select ThinkPad notebooks and ThinkCentre desktops. Wave's partnership with IBM enables Wave in its objective to sell and develop open and interoperable solutions to business customers as trusted computing continues to evolve. **This licensing agreement is non-exclusive and there are no minimum licensing requirements on the part of IBM pursuant to the agreement.** Wave will try to interest other security chipmakers and motherboard suppliers in its product in the coming months.

(Emphasis added.)

83. On August 22, 2003, the Individual Defendants caused the Company to file a Prospectus with the SEC relating to the registration of 12,593,880 shares of Class A Common Stock. The Prospectus made the following representations under "Material Changes":

On July 31, 2003, Wave announced an agreement with Intel Corporation that will help enable both companies to accelerate the development and deployment of trusted applications and services for safer computing on personal computer platforms. The agreement will enable Intel to bundle Wave's software and services with a future Intel desktop motherboard, targeted for trusted computing platforms. Similar in nature to a previously announced March 2003 licensing agreement between Wave and National

Semiconductor, Intel will pay a royalty fee to Wave for each unit shipped. This licensing agreement is non-exclusive and there are no minimum licensing requirements on the part of Intel pursuant to the agreement. Intel plans to introduce the new motherboard in the fourth quarter of 2003.

On August 4, 2003, Wave announced that it has partnered with IBM's Independent Software Vendor (ISV) Program. Wave's new Document Manager Vault and SmartSignature security software applications in Wave's EMBASSY Trust Suite client software family now work with the IBM Embedded Security Subsystem, a hardware and software-based security solution available on select ThinkPad notebooks and ThinkCentre desktops. Wave's partnership with IBM enables Wave in its objective to sell and develop open and interoperable solutions to business customers as trusted computing continues to evolve. **This licensing agreement is non-exclusive and there are no minimum licensing requirements on the part of IBM pursuant to the agreement.** Wave will try to interest other security chipmakers and motherboard suppliers in its product in the coming months.

(Emphasis added.)

84. The Individual Defendants' statements contained in the Company's SEC filings described in ¶¶81-83 were materially false and misleading at the time they were made. The Individual Defendants knew that the Intel deal would not generate the revenue stream forecasted by the Company at any time in the foreseeable future, if ever, and that the IBM relationship was not fee producing and was not a "licensing agreement." Contrary to the Individual Defendants' representations, the purported Intel and IBM deals were not "material changes."

85. On November 13, 2003, the Individual Defendants caused the Company to issue a press release entitled "Wave Systems Provides Update on Corporate Progress and Reviews Q3/Nine Months Results." The press release stated in part:

Wave Systems Corp., a leader in delivering trusted computing applications and services with advanced products, infrastructure and solutions across multiple trusted platforms, today reported

results for its third quarter and nine month ended September 30, 2003 and reviewed significant recent corporate developments.

* * *

Steven Sprague, Wave's president and CEO, said, "We can now clearly see the growing momentum for trusted computing in the marketplace, and we expect substantial growth in volumes over the course of the next four quarters.

"Wave has clearly focused in establishing technological and market leadership in this space as a services and infrastructure provider. We have delivered products that are easy to install, easy to configure, easy to use and are what business users really need.

"We continue to add functionality and capability to the EMBASSY® Trust Suite tapping into Wave's expertise in building trusted computing services and infrastructure and responding to the needs of the marketplace. Wave's ETS works seamlessly on all six Trusted Computing Group-compliant, commercially available platforms today. We are now focusing on delivering to the market a portfolio of powerful client and server software solutions that we expect will give IT managers exceptional life cycle management capabilities and impressive cost-of-ownership results."

86. On November 19, 2003, with the Company's shares inflated, the Individual Defendants caused the Company to issue a press release entitled "Wave Systems Completes \$7.1 Million Private Placement Financing." The press release stated in part:

Wave Systems Corp., a leading developer of trusted computing solutions and services, announced today that it has completed a \$7.1 million private placement of Class A common stock and warrants with a group of institutional and accredited investors. The financing is intended to fund Wave Systems' ongoing operations, specifically its sales and marketing efforts, as well as its engineering, development and customer support teams and its general corporate overhead.

The private placement consists of 3,725,263 shares of common stock priced at \$1.90 per share as well as warrants to purchase 1,095,227 shares of the company's common stock at an exercise price of \$2.62 per share. If exercised in their entirety, the warrants would generate an additional \$2.9 million in gross proceeds to

Wave. J. P. Carey Securities acted as the agent for the private placement.

The SEC Investigation

87. On December 18, 2003, the Individual Defendants caused the Company to issue a press release entitled "Wave Systems Notified of SEC Investigation." The press release stated in part:

Wave Systems Corp. today reported that the Securities and Exchange Commission has commenced a formal investigation into certain matters relating to Wave. The SEC's investigative order, received by Wave on December 17, 2003, relates to certain public statements made by Wave during and around August 2003, as well as certain trading in Wave's securities during such time.

88. On this news, Wave Systems shares fell 17.13% or \$0.31 per share to close at \$1.50 per share on December 18, 2003, on extremely heavy volume.

89. As reported in The San Diego Union-Tribune on December 20, 2003, the SEC investigation focused on the statements by the Individual Defendants and the Company which began the stock's rally: "U.S. regulators are formally investigating certain public statements from the company that sent its stock soaring last summer. Yesterday the company's shares fell 17 percent.... The company's stock quadrupled in value in heavy volume trading in the days around the announcements."

90. As a result of the Individual Defendants actions, Wave Systems' market capitalization has been damaged by over \$183 million. At the same time that the Individual Defendants were causing Wave Systems to suffer such devastation of its market capitalization, reputation and goodwill, the Insider Selling Defendants fared much better by selling over \$1 million of their personally held stock.

DERIVATIVE AND DEMAND FUTILITY ALLEGATIONS

91. Plaintiffs bring this action derivatively in the right and for the benefit of Wave Systems to redress injuries suffered, and to be suffered, by Wave Systems as a direct result of the breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment, as well as the aiding and abetting thereof, by the Individual Defendants. Wave Systems is named as a Nominal Defendant solely in a derivative capacity. This is not a collusive action to confer jurisdiction on this Court that it would not otherwise have.

92. Plaintiffs will adequately and fairly represent the interests of Wave Systems in enforcing and prosecuting its rights.

93. Plaintiffs were owners of the stock of Wave Systems during all times relevant to the Individual Defendants' wrongful course of conduct alleged herein, and remain shareholders of the Company.

94. The current Board of Directors of Wave Systems consists of the following five individuals: Defendants Steven Sprague, Bagalay, Bushnell, Gilder and McConnaughy. Plaintiffs have not made any demand on the present Board of Directors of Wave Systems to institute this action because such a demand would be a futile, wasteful and useless act, particularly for the following reasons:

a. As a result of their access to and review of internal corporate documents; conversations and connections with other corporate officers, employees and directors; and attendance at management and Board meetings, each of the Defendants knew the adverse non-public information which made the representations made by the Company false and misleading. While in possession of this material

adverse non-public information regarding the Company, the following current members of the Wave Systems Board participated in the illegal insider selling; and

i. During the Relevant Period, Steven Sprague sold 150,000 shares of Wave Systems stock for over \$500,000. Because this Defendant received a personal financial benefit from the challenged insider trading transactions this Defendant is interested and any demand upon him is futile;

ii. During the Relevant Period, Bushnell sold 10,000 shares of Wave Systems stock for \$35,742. Because this Defendant received a personal financial benefit from the challenged transaction, this Defendant is interested and any demand upon him is futile;

b. The Compensation Committee of the Board determines the compensation level of the Company's executive officers and administers the Company's stock option plans. The Compensation Committee is comprised of Defendants McConaughy and Bagalay. As the members of the Compensation Committee singularly control the other Defendants' awards, the remaining members of the Board will not institute this action against Defendants McConaughy and Bagalay. To do so would jeopardize each Defendant's personal financial compensation. Thus, demand on Defendants Steven Sprague, Bushnell and Gilder is futile;

c. The principal professional occupation of Defendant Steven Sprague is his employment with Wave Systems, pursuant to which he received and continues to receive substantial monetary compensations and other benefits. For the year 2003, Wave Systems paid Steven Sprague \$450,000 in salary and bonus and granted him 225,000 options to purchase Wave Systems stock. Accordingly, Defendant Steven

Sprague lacks independence from Defendants McConnaughy and Bagalay, Defendants who are not disinterested/independent and who exert influence over Defendant Sprague's compensation by virtue of their position as members of the Compensation Committee. This lack of independence renders Defendant Steven Sprague incapable of impartially considering a demand to commence and vigorously prosecute this action;

d. According to Wave Systems' Proxy Statement filed with the SEC, Defendants McConnaughy, Bagalay and Bushnell were, during the Relevant Period, members of the Audit Committee. The Audit Committee is responsible for reviewing auditing procedures and the adequacy of the Company's internal control systems. Nonetheless, the Audit Committee abdicated its oversight responsibilities to the Company and its shareholders. By such actions, Defendants McConnaughy, Bagalay and Bushnell breached their duties and face a substantial likelihood of being held liable for same. As a result of these Defendants' breach of their duties, any demand upon them is futile;

e. The entire Wave Systems Board of Directors and senior management participated in the wrongs complained of herein. Wave Systems' directors are not disinterested or independent due to the following: Defendants Steven Sprague, Bagalay, Bushnell, Gilder and McConnaughy served on the Wave Systems Board during the Relevant Period. Pursuant to their specific duties as Board members, each was charged with the management of the Company and to conduct its business affairs. Each of the above-referenced Defendants breached the fiduciary duties that they owed to Wave Systems and its shareholders in that they failed to prevent and correct material misrepresentations made by the Company. Thus, the Wave Systems Board cannot